

Entity choice: Opportunities and traps

William P. Prescott, Esq., MBA

THIS IS THE FIRST of a two-part article that discusses entity choice and maintenance for the practice and real estate entities. The first part deals with liability protection, entity formation, entity maintenance, and dissolution.

There are five entities, plus some hybrids, for practice and related entity operation. They are sole proprietorships, C corporations, S corporations, limited or professional limited liability companies (LLCs), and general partnerships (partnerships).

LIABILITY PROTECTION

While a sole proprietorship is the simplest entity form, it offers no liability protection, absent insurance. A partnership also offers no liability protection absent insurance. If two or more dentists practice together without forming any other entity, they are a partnership by default and partners are jointly and severally liable for the acts of other partners. Thus, because LLCs can elect to be taxed as either a partnership or other entity, it makes sense to maintain the liability protection afforded to an LLC rather than a partnership, except in those few states where dentists are not permitted to practice through LLCs.

How can operating as a sole proprietorship or partnership insulate a dentist against liability? The dentist should consider carrying an umbrella insurance policy that effectively insures the dentist and practice against what the dentist wants to insure. In addition, the dentist should consider carrying an employment practices liability insurance policy.

Most of all, the dentist, with the practice as the plan sponsor, should consider adopting and funding a tax-qualified retirement plan, (e.g., a safe harbor 401(k) profit-sharing plan for younger doctors) or a defined benefit or

cash balance plan for older doctors who have not saved to contribute more. Unlike SIMPLE plans and IRAs, tax-qualified plans are absolutely creditor proof, except for child support orders and federal tax liens, provided that the owner is not the only participant in the plan.

S corporations, LLCs, and C corporations do offer liability protection, except for alleged or actual malpractice. The decision to form an S corporation, LLC, or C corporation versus a sole proprietorship or partnership should be based on two criteria. First, the greater the number of employees in the practice or other entity, the greater the need to consider an entity that provides liability protection. Second, if there is more than one dentist in the practice, it is essential to consider operating in an entity that provides liability protection. While a dentist is always liable for his or her own acts, an entity that provides liability protection protects the practice owners from the acts of other partners and dentists and, hopefully, from claims of practice employees against the practice owners.

However, practicing through or forming a C corporation is a bad choice because of the double tax on distributions on the sale of the practice. Even though the C corporation tax rate is reduced from 35% to 20%,¹ it is still better to practice as an S corporation rather than pay 20% plus the ordinary income rate. Sale of practice proceeds are taxed twice, unless the practice can successfully show and prove² that the largest portion of the practice sale—goodwill—is personal

and taxed at one level.³ If the practice is organized as a C corporation and the owner plans to practice at least 10 more years, consider converting to an S corporation. The 10-year period treats the newly elected S corporation as a C corporation.⁴

ENTITY FORMATION

In forming an S or C corporation for the practice, articles of incorporation are prepared and filed with the secretary of state. Each state has different filing requirements. Simultaneous with filing the articles, the shareholder makes an initial capital contribution into a bank account, (e.g., \$500 or \$1,000). The corporation will also be required to name a statutory or registered agent. After the entity formation is approved by the state, proceedings of the incorporator and a code of regulations (or policies that follow state law regarding the corporation's operations) are prepared. In addition, shareholder and director minutes and a share journal and share ledger are prepared. Finally, share certificates are issued to each of the shareholders.

In forming an LLC, articles of organization are prepared and filed with the secretary of state, and the initial capital contribution is made, along with naming the statutory or registered agent. Thereafter, a single or multimember operating agreement is prepared. Membership certificates are issued evidencing ownership. For multimember LLCs, it is preferred they prepare and maintain a company record book. While LLCs have been touted as having the liability protection afforded to corporations without maintaining corporate formalities, oftentimes membership interests are sold or gifted, (particularly where real estate is involved e.g., gifts to children). In such cases,

ENTITY CHOICE

maintaining up-to-date records of ownership is imperative.

ENTITY MAINTENANCE

It is not enough to form an S or C corporation. In all states, the corporate entity must “look and act” like a corporation to ensure liability protection is present. Corporate formalities are maintained through preparation of annual shareholder and director minutes. The minutes provide that the shareholders elect directors and the directors elect officers. Minutes delineating the significant corporate activities that the S or C corporation takes each year are included in the corporation’s record book. The record book is usually retained and maintained by the client’s law firm so that minutes are up-to-date. A year-end information sheet should be sent to each client and his or her respective CPA ahead of the taxable year-end for completion. Table 1 is an example of a year-end information sheet.

ENTITY DISSOLUTION

Once the practice is sold in a complete sale, the practice is eventually dissolved. For example, if a practice is sold and accounts receivable are collected for some period of time following closing and, after all outstanding payables are paid, the retirement plan is terminated with assets being rolled into an IRA, and the corporation or LLC is formally dissolved under the applicable state law. If there is a surviving or remaining owner where there is more than one owner, the practice entity continues under the same tax identification number.

SUMMARY

While I have encountered many very successful sole proprietors as practice owners through the years, my recommendation is to practice as a separate entity that provides liability protection, not for alleged or actual malpractice, but for acts of third parties, (e.g., employees). **DE**

REFERENCES

1. 2017 Tax Cuts and Jobs Act. Pub.L. 115-97.
2. *Kennedy v. Commissioner*, T.C. Memo. 2010-206.
3. Prescott WP. The current status of personal goodwill. *Dent Econ*. 2016;106(10):54,56.
4. Internal Revenue Code Section 1374.

TABLE 1
Year-End Information Sheet

NAME OF CORPORATION John Smith, D.D.S., Inc. FISCAL YEAR ENDING December 31, 20

CLIENT NO. 9999.001

(A) DIVIDENDS: Date Declared: _____ Amount Per Share: \$ _____
Date Paid: _____ Total Amount Paid: \$ _____

(B) PROFIT-SHARING: Total Amount (or percentage) contributed to Plan: \$ _____ % _____

(C) TOTAL COMPENSATION (Basic Salary PLUS all bonuses) paid to key, management employees (Shareholders, Directors, Officers) during the fiscal year:

(D) MANAGEMENT FEES PAID IN EXCHANGE FOR MANAGEMENT SERVICES RENDERED.
Date Paid: _____ Amount Paid: \$ _____
Recipient: _____

Name of Employee	Basic Salary (According to Employment Agreement)	TOTAL Bonuses Paid*	If Accrual Basis Taxpayer, TOTAL Bonuses Accrued	TOTAL COMPENSATION
_____	\$ _____	\$ _____	\$ _____	\$ _____
_____	\$ _____	\$ _____	\$ _____	\$ _____
_____	\$ _____	\$ _____	\$ _____	\$ _____

*Please also list bonuses in Item (D), below:

(E) BONUSES: All other employees. (Please attach additional sheets, if necessary)

Name of Employee	Bonus Paid	Date Paid	Bonus Accrued	Date Accrued	Was this a Holiday Season Bonus?
_____	\$ _____	_____	_____	_____	No Yes
_____	\$ _____	_____	_____	_____	No Yes
_____	\$ _____	_____	_____	_____	No Yes

(F) SALARY INCREASES:

Name of Employee	Effective Date	Old Salary	New Salary
_____	_____	\$ _____	\$ _____
_____	_____	\$ _____	\$ _____
_____	_____	\$ _____	\$ _____

(G) MAJOR CORPORATE CAPITAL EXPENDITURES: (Over \$5,000.00):**

Item	Date Purchased	Cost
_____	_____	\$ _____
_____	_____	\$ _____
_____	_____	\$ _____

** (Note — If item purchased/sold was an automobile, list whether it was (a) purchased, or (b) sold, total purchase/sale price, date purchased/sold, year and make of car, indicate if car is for Corporate use only (or the particular person that will be using car) and give details (if applicable) for financing, (e.g., financing institution, amount borrowed, date borrowed, interest rate and payment schedule).

(H) SEMINARS AND CONVENTIONS ATTENDED:

Date Attended	Date Expenses PAID	Place	Subject	Attendees
_____	_____	_____	_____	_____
_____	_____	_____	_____	_____

(I) MISCELLANEOUS TRANSACTIONS (e.g., institution of benefit plans (e.g. Medical, Group-Term Life, Disability, Employee Expense Reimbursement Accountability), real estate or equipment leases, amendments to the Articles of Incorporation or Regulations, fiscal year changes, statutory agent changes, change of business address, charitable contributions, directors’ fees, membership dues, reimbursement of expenses, etc.) Please give important details (e.g. date, amounts, etc.).

(J) No change in Officers and/or Directors (check if applicable).

(K) If (D), above, not checked, then please list Officers and/or Directors.

President: _____ Secretary: _____
Vice-President: _____ Treasurer: _____
Vice-President: _____ Other (if any): _____
Directors: _____

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Table 1: Example of a year-end information sheet



WILLIAM P. PRESCOTT, ESQ., MBA, of Wickens Herzer Panza in Avon, Ohio, is a practice transition and tax attorney and former dental equipment and supply general manager and representative. His most recent

book is titled *Joining And Leaving the Dental*

Practice, third edition, available through the ADA Center for Professional Success. ADA members can download the e-book for free at success.ada.org/en/practice-management/joining-and-leaving-the-dental-practice. For this and Mr. Prescott’s other publications, see prescottDentalLaw.com. Mr. Prescott can be contacted at (440) 6958067 or wprescott@wickensLaw.com.